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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1935

No. 12

AMERICAN SURETY COMPANY OF NEW YORK,
a Corporation,

Petitioner,

vs.

WESTINGHOUSE ELECTRIC MANUFACTURING COMPANY, a Corporation, et als.

Respondents.

BRIEF OF RESPONDENTS

WILLIAM FISHER,
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BRIEF OF RESPONDENTS

Opinion of the Court Below

The opinion of the Circuit Court of Appeals for the Fifth Circuit is in American Surety Company of New York vs. Westinghouse Electric Manufacturing Company et al 75 Fed. 2nd 377.

Statement of Facts

The statement of facts in the brief of petitioner is correct. It does not clearly appear in the Statement of Facts although it may be implied from the facts as stated, that prior to any of the proceedings involving the balance of Twenty-seven Hundred Twenty-four and 23/100 ($2,724.23) Dollars due by the Government to M. J. Gray as the balance of the contract price, the contracted work had been completed by Gray and accepted by the Government, and that the Government's only remaining interest in the matter was that the money be paid to the claimant having the best right to it. (R. 50-R58).

See American Surety Company of New York vs Owens et als 66 Fed. 2nd, 190 for the final result of the case referred to on pages 50 and 58 of the record.

Summary of Argument

The basis of petitioner's argument in support of its superior right to the fund in question here is that the unpaid laborers and materialmen have no equitable lien on or equitable right to priority of payment out of the fund which their labor and materials created; that they occupy with respect to the fund, a position no better than that of any general creditor of Gray whose claim has no connection with the contract or with the fund.

The brief argues its Point I concerning the Surety's right in the fund upon the premise that the respondents have no special equity in the fund. It does not discuss a contest of equities, but relies upon an equitable right in the Surety, and none in the labor and material claimants.

If the petitioner's premise be correct, and if the unpaid labor and material claimants have no special equity in the fund, and no better standing than that of any general creditor of Gray, then the respondents are knocked out in the first round. And there is no need of all the logomachical sparring on the proposition of the surety's rights. Because the respondents have no hesitancy in conceding that the Surety, to the extent it has paid money on account of its suretyship obligation, and by reason of such payment, has acquired a right to the fund superior to the rights of certain other possible claimants, such as a general creditor of the contractor, or an assignee of the contractor, or the contractor himself. So that if there were *no* unpaid labor and material claimants and if the contest here were one between the Surety and a general creditor, an assignee, or the contractor himself, we think the right of the Surety to the fund would be unassailable. But the contest in this case is between the Surety on the one hand, and on the other hand, the laborers and materialmen for the prompt payment of whose claims the Surety was obligated on its bond. It is

a contest of equities between the parties who occupy a certain status toward each other and toward the principal contractor.

For that reason we do not follow the order in which the points are presented in petitioner's brief. But we discuss first the question whether, the Government having been fully satisfied by performance, and none of its rights being involved, the labor and material claimants have any special equity in or an equitable lien on the fund. And secondly, whether the equity which the labor and material claimants have is subordinate to the equity claimed by the surety; and whether the surety occupies such a relationship toward the labor and material claimants as to prevent its competition with them for the fund until their claims have been paid in full.

1.

The Government having been fully satisfied by performance and none of its rights being involved, have the labor and material claimants a special equity in or an equitable lien on the fund?

Petitioner argues that the labor and material claimants can have no equitable lien on the fund because: (1) There is no express contract for such lien; (2) because there is no Statute creating such lien; and (3) because there is no basic reason for implying such lien. It admits, however, that an equitable lien is not dependent upon either an express contractual or a Statutory basis, but may arise by implication out of general considerations of right and justice, where from the relations of the parties and the circumstances of their dealings there is some obligation or duty to be enforced by means of such an implication. For the general principle there is ample authority.

Vidal vs S. A. Securities Corporation 276 Fed. (2nd Cir) 855

Shakers vs Watson 68 Fed. (6th Cir.) 730

Oppenheimer vs Szulerecki (Ill.) 130 N. E. 325

37 Corpus Juris 319

17 R. C. L. 605
Exchange State Bank vs Federal Surety Co., 28 Fed. 2nd (8th Cir.) 485.

The Government has for many years recognized a moral and equitable responsibility to see that persons furnishing labor and material for public work were paid. The Statute under which the bond in the instant case was given (40 U.S. C.A. Section 270) was passed because of the inability of the furnishers of labor and material to acquire a lien upon the public work itself and in derogation of the title of the Government in the work. The Statute was designed to provide an equivalent or substitution for lien legislation.

U. S. vs Ansonia Brass and Copper Co. 218 U. S. 452
U. S. vs Churchyard 132 Fed. 82 Affirmed 204 U. S. 349.

The Statute is susceptible of and should receive a more liberal construction for the benefit of those it is designed to protect, than the ordinary lien Statute.

American Surety Co., vs Lawrenceville Cement Co. (C.C.A.) 110 Fed. 717

And the Statute has always been liberally construed to protect those furnishing labor and materials on public work.

Brogan vs National Surety Company 246 U. S. 257
Illinois Surety Co. vs Davis 244 U. S. 376
Equitable Surety Company vs U. S. 234 U. S. 448

Prior to the amendment in 1905 of the Act passed in 1894, the United States had no priority of rights under the bond as against the laborers and materialmen.

American Surety Co. vs Lawrenceville Cement Co., 135 Fed. 78
United States vs Heaton 128 Fed. 414

And in the bonds given pursuant to the Statute, the laborers and materialmen occupy the status of obligees just as the Government does. The Government is the obligee so far as the obligation for performance is concerned, while laborers and materialmen are distinct obligees so far as the prompt payment of their bills is concerned.

Equitable Surety Co., vs United States 234 U. S. 448
United States vs National Surety Co. 92 Fed 549

Henningsen vs U.S . F. & G. Co., 143 Fed. 810
Glades County Bank vs Detroit F. & S. Co., 57 Fed. 2nd, (5th Cir.) 449

The Henningsen case (Henningsen vs U. S. F. & G. Co., 208 U. S. 404) discussed in petitioner's brief and referred to hereinafter, says that the Government is under an "equitable obligation" to see that laborers and materialmen are paid for their contributions to the contracted work.

In recognition of the Government's attitude toward the laborers and materialmen, and of its design and purpose to furnish them protection, as well as of its equitable obligation to them, the Federal Courts have, with practical unanimity, held that unpaid laborers and materialmen have an equitable lien upon the balance due a public contractor upon completion of the work under the contract.

Alfred Richards Brick Co., vs Rothwell 18 App. D. C. 516
In re Scofield 215 Fed. 144
In Re P. McGarry 240 Fed. 400
Cox vs New England Equitable Ins. Co. 247 Fed. 955
Belknap Hardware Co., vs Ohio River Co. 271 Fed. 144
Exchange State Bank vs Federal Surety Co., 28 Fed. 2nd, 485
Philadelphia National Bank vs MacKinley (App. D. C.) 72 Fed. 2nd, 39
(Certiorari denied Oct. 8th, 1934 ..... U. S. ..... 79 L. Ed. 101)

The opinion in Alfred Richards Brick Company vs Rothwell (supra) says:

> "The Act bears every evidence that it was intended to provide a security for laborers and materialmen on which they could rely confidently for protection, unless they see fit by their own dealings with the contractor to relinquish the benefit of the security. There is, therefore, by necessary implication, an equitable lien and preference secured in favor of the parties who furnish labor and materials in the execution of the contract, in the application or distribution of the contract price remaining to be paid; and where the Government, as in the present instance, holds in its hands

> any part of the money contracted to be paid for the work, and there remain unpaid claims for labor and materials supplied, it holds such funds as quasi-trustee for the benefit of those entitled to receive it under the condition in the bonds; that is to say, the laborers and maerialmen remaining unpaid."

In Re Scofield (supra) the question the Court decided was (Text 47 of 215 Fed.):

> "Whether under the circumstances stated, the Surety of the bankrupt contractor who has paid the claims of the laborers and materialmen has any equity in the so-called reserved fund which it can assert to the exclusion of the general creditors."

The Court then discusses the rights of laborers and materialmen before the passage in 1894 of the Statute requiring a bond for their protection, holds that the contract and bond are to be construed together as the entire contract, and decides the question above stated in favor of a special equity in the surety derived from the claims of laborers and materialmen which it has paid; the Court saying:

> "When the Fidelity Company assumed the obligation of suretyship its equity at once commenced with **its obligation to see that the Scofied Company duly performed all the obligations which the contract with the Government imposed upon it, including its obligations to promptly pay the laborers and materialmen."** (Blackface supplied).

In Cox vs New England Equitable Ins. Co. (supra) the right of the surety to an equitable lien on the balance of the contract price was derived from the right of the laborers and materialmen whom it has paid. And the same is true of in re McGarry, supra.

Belknap Hardware Company vs Ohio River Co. (supra) has this to say of the Henningsen case (Text 148-149 of 271 Fed.):

> "The case was essentially different from the Prairie State Bank case, because there the Surety had taken over and completed the contract and the performance of the contractor's obligation to the United States as the other party to the contract, and so had become en-

titled to the security which the United States held against the contractor; in the Henningsen case, the contractor himself had completely performed the contract and had finished the work. It would seem, therefore, that subrogation in the Henningsen case could not be to any security which the United States held against the contractor; there was no such element in the case. The Surety's claim of priority in the fund was sustained and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think, the necessary effect of the decision is to hold that laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the Court (208 U. S. 407, 408, 28 Sup. Ct. 389, 52 L. Ed. 547) that there could be no such subrogation without such a right and that there was no such right. On page 410 of 208 U. S., on page 391 of 28 Sup. Ct. (52 L. Ed. 547) the Court refers to and assumes that the Government, after the bond was given was still charged with 'equitable obligations to see that the laborers and supply men were paid. We are constrained to think that the decision necessarily rests upon the existence of this right, as one entitling these claimants to priority in payment out of the fund, and therefore, as entitling the surety, as their equitable assignee by subrogation, to the same priority."

And in Philadelphia National Bank vs McKinlay (1934-supra) it was held (2nd Headnote):

> "Person furnishing labor and material for Government project has equitable lien on the contract price until fund is paid to general contractor, irrespective of statutory bond."

In adition to these authorities, many of the cases cited by petitioner as sustaining the right of surety in unpaid balances on a public contract, recognize the equitable rights of laborers and materialmen, and derive the Surety's right from them through payment by the Surety of their claims. As for instance, Wasco vs New England Equitable Co., (Ore.) 172 Pac. 126, where the contest was between a surety who had paid labor and material claims in full, and a Bank

assignee of the contractor. And Johnson Service Co., vs Monin 253 N. Y. 417, 171 N. E. 682 which did not involve a contest between a surety and a materialman, but which recognized the equitable right of the materialman to be paid out of the reserve fund. And Illinois Surety Co., vs City of Galion 211 Fed. 161 in which the Court said:

> "I am of the opinion that the fund now in Court is subject to the payment of all unpaid labor and material claims that went into the work of construction of the sewage disposal plant at Galion and that the complainant has the right in equity to see that this money, which has been paid into Court, should be applied to the liquidation of all claims for material and labor that have arisen under the contract in question . . . . ."

in deciding the case against a bank creditor of the contractor.

And of the authorities cited on page 40 of petitioner's brief as holding against the existence of an equitable lien in favor of laborers and materialmen, only two, viz: Robinson vs Blaylock (N.C.) 135 S. E. 136, and American Surety Co., vs Finletter 274 Fed. 152, both of which involve State Statutes and contracts other than Federal, support petitioner's theory. Freeny vs Bauernschmidt 33 Fed. 2nd, 709 involved no Statute such as the one here in question, and was decided upon authority of the Maryland cases which had established the rule which the Federal Court followed. In Pratt Lumber Co., vs Gill 278 Fed. 783, no rights of laborers and materialmen were involved, and in the case the Court cited with approval Alfred Richards Brick Co., vs Rothwell, supra (18 App. D. C. 516). In re Fowle 213 Fed. 676 was a case where there was no provision in the bond requiring the contractor or his surety to pay labor or material claims. Kellas vs Slack 99 Atl. 677 is another Maryland case involving no Statute or bond, but in the case the equitable right of a labor and material claimant was upheld as against an assignee of the fund, no right of the public authority being adversely affected. Sexaver and Lemke vs Burke (N.Y.) 127 N. E. 319 involved the New York mechanics' lien law and its effect upon a private owner. Southern Surety Co., vs Schlesinger, as cited on page 40 of

petitioner's brief apparently should be Southern Surety Company vs Merchants and Farmers Bank (Ind.) 176 N. E. 846.

That case is direct authority supporting the equitable rights of laborers and materialmen. The Surety was held not to be entitled to subrogation because it had not paid the laborers and materialmen. And the Court held that the order of he Court below relative disposition of the balance of the contract price "should have been that the County officials pay said retained fund into Court and directed the Clerk to apply the same pro rata on the labor and materialmen's judgments, as said judgments amounted to more than said fund, and this shall be the order of this Court, with the further direction that in the event said labor and material men's judgments has (sic) been paid by appellant, then said money to be paid to appellant herein."

Robinson vs Blaylock, supra, involving a North Carolina statute, and contractor's bond, is however direct authority supporting petitioner's contention. The North Carolina Court refuses to recognize the equitable lien theory in favor of laborers and materialmen which the Federal Courts have enforced.

And American Surety Co., vs Finletter, supra, is construed by petitioner as holding that labor and material claimants on a Pennsylvania municipal contract have no better status than general creditors with respect to reserved funds. We think that is the result which may be deduced from the opinion in the case, and, if the deduction is correct then the case is authority against the claim of the respondents to an equitable lien. The same case in the District Court appears to be Peoples vs Peoples Bros. 254 Fed. 489 which held, on the same proposition as that decided in the Finletter case, that the surety

> "on completion of the contract by a receiver was not entitled to subrogation to the amount due thereon until claims for labor and materials were paid in full."

The Peoples case has been cited with approval in the following cases:

Maryland Casualty Co., vs Fouts 11 Fed. 2nd, (4th Cir.)

American Surety Co. vs National Bank (D. C. Oh.) 17 Fed. 2nd, 942

Pou vs South Carolina Warehouse Co., (D.C.) 27 Fed. 2nd, 418

United States vs National Surety Co., 254 U. S. 73

Jenkins vs National Surety Co., 277 U. S. 258

so that the weight of the authority as between the Peoples case and the Finletter case would appear to sustain the respondents in the instant case, rather than the petitioner.

So much for the authorities which have passed upon the question of whether or not laborers and materialmen have an equitable lien upon or equitable right of priority of payment from the balance due upon a public contract, the Government having been fully satisfied by the performance of the contract by the contractor. From Alfred Richards Brick Co., vs Rothwell, supra, decided in 1901, on down through In Re Scofield, supra, and other cases cited, together with Henningsen vs U. S. F. & G. Co., supra, (208 U. S. 404) the Federal Courts have, without exception so far as Federal contracts are concerned, accorded definite recognition to the equitable rights of laborers and materialmen, so long as no adverse rights of the Government existed.

One of the time worn arguments against the existence of an equitable lien in favor of laborers and materialmen, and one which petitioner urges in its brief, is that the recognition of such a lien by the Courts must necessarily open the way for laborers and materialmen to embarrass the Government; and that such lien will necessarily limit the right of the Government to use the proceeds of a public contract for its own protection, or to disburse such proceeds in its inrestricted discretion. The brief says (Page 36) "If the Government has an equitable obligation that transcends even the bond, it is timely to inquire as to the limitations of this obligation."

The Courts have found no such difficulty in their equitable lien cases. It certainly is not necessary, in the conception of such a lien, to say that the lien would destroy the paramount right of the Government to a complete per-

formance of the contract as to it or would hamper its unrestricted discretion in the disbursement of the contract proceeds in accordance with the terms of the contract. A lien even on tangible property frequently is effective as between certain parties to a transaction and ineffective as to other parties to the same transaction. And an equitable lien dealing with intangible property, such as this case, presents no technical difficulty to a Court called upon to pass judgment on such relative equities as various parties to a transaction may acquire in the course of the transaction. And it does not necessarily follow that recognition of the existence of an equitable lien in a case such as this where the Government has not paid the contractor but has delivered the money into Court for the purpose of having it paid to the claimant with the best right to it, that the Government could not have paid out the money to the contractor, under the terms of the contract, free from a lien.

Besides, how can the equitable lien of the labor and material claimants embarrass or hamper the Government to any greater extent than the Surety's claim of an equitable lien or equitable priority in the fund? The Government had in its hands the unpaid balance due on the contract. The Surety claimed the right to bring the Secretary of the Navy into Court to require that the money should be paid to it. Yet it urges that to permit a labor or material claimant to do the same thing is such a destructive and pernicious theory as to render the existence of an equitable lien in his favor impossible. The Surety in Glades County Bank vs Detroit F. & S. Co., 57 Fed. 2nd, 449, went into Court to compel the public authority to make disbursements of the proceeds of a public contract to the laborers and materialmen whom the surety claimed the right to have paid out of such proceeds. Certainly, the recognition of an equitable lien in laborers and materialmen as against the contractor upon his default in payment of claims, or as against his assignee or his general creditors, would not have to mean that the same lien would exist as against the Government's rights under the contract.

Petitioner argues that it is reasonable to assume that the laborers and materialmen relied for the collection of their money, wholly upon the contractor's financial stability and upon the penalty of the bond, and that therefore they can have no equitable lien on the proceeds of the contract. The amount of the contract was $13,133.36 (R9) plus $2109.64 (R23) or a total of $15,243.00. This minus the contractor's profit would constitute the cost of the labor and materials necessary to create the structure the contract called for. The bond, a part of the contract, obligated the principal that he should "promptly make payment to all persons supplying the principal with labor and material in the prosecution of the work". (R 20). The contract (R 17) provided for partial payments by the Government from time to time, obviously for the purpose of enabling the principal to pay for the work as it was being carried on. And the contract also provided (R 17) that "All material and work covered by partial payments made shall thereupon become the sole property of the Government . . . . ." The penalty of the bond was only $3940.00. It seems to us a much more reasonable assumption that laborers and materialmen would know that it would take the payments made by the Government from time to time on account of the contract price to pay their claims for labor and materials furnished. And that they would rely upon the contract payments by the Government for payment, and on the penalty of the bond only for any deficiency after full use of the proceeds of the contract. That would be the view, too, we take it, of the Government, and of the surety and of the principal contractor. And that arrangement is all the respondents have ever asked for, that the proceeds of the contract be applied as far as they will go to pay their bills, and that the bond penalty supply the deficiency.

And petitioner argues that a discretionary retention of funds under the contract does not establish an equitable lien on the funds. In re Scofield Co., supra and Greenville Savings Bank vs Lawrence (CCA 1896) 79 Fed. 545, say that funds retained, even if they were retained under a discretionary right, were, under circumstances as they exist

in the instant case, subject to an equitable lien in favor of the laborers and materialmen. Kane vs First National Bank (5th Citr.) 56 Fed. 2nd 534, cited by petitioner to support this contention concerned funds which had **not** been retained, but which had been paid out by the Public Authority to the principal contractor and by him disbursed. But we do not think that respondents' rights are dependent upon the provisions of the contract fixing the times at which or the manner in which the contract proceeds are to be paid by the Government to the contractor.

We confess ourselves unable to follow the distinction, so far as an equitable lien in respondents is concerned, between the 10% reserved fund in the contract, and any other unpaid portion of the contract proceeds. Such a distinction is a valid one where a question of the release of the surety is claimed by reason of premature payments made by an obligee in the bond. But here the contract had been fully performed and $2724.23 remained of the contract proceeds payable, but unpaid, to the contractor. The surety had not been called upon to perform any part of the contract obligation to the Government. And regardless of the purpose of the 10% reserved fund to safeguard the completion of construction, construction had been completed and the 10% reserved fund was in no different situation than any other unpaid portion of the contract price. It seems to us that the 10% provision in the contract is simply a provision fixing the time of payment of that amount rather than a distinct allocation of that percentage to any different purpose from the purpose of any other portion of the contract price. For it seems clear that if a contractor should default when he has collected only some, or none, of the partial payments provided to be made from time to time as the work progresses, then the unpaid partial payments would be usable by the Government in the same manner, for the same purpose and to the same extent as the 10% reserved fund. See McGowan vs United States 35 Ct. Cl. 606 (1900) and United States vs U. S. F. & G. Co. (1915) 236 U. S. 512.

It is difficult to see how the times at which the contract says partial payments are to be made to the contractor, can

have any effect upon the equitable obligation which the Government recognizes to see that, subject to its paramount right of complete performance as to it, the laborers and materialmen whose work and materials created the the fund should be paid.

The petitioner argues that the lien of respondents must be limited to that part of the contract proceeds which the Government had no discretionary power to pay out. Why? What is the difference between the two funds unless the equitable lien is held to exist only because of some express allocation under the terms of the contract? The petitioner attempts to divide the $1524.00 which constitutes 10% of the contract price, and to limit respondents' rights to half of the $1524.00, because the contract provides (R 17): "In making such partial payments there shall be retained 10 per cent on the estimated amount until final completion and acceptance of all work covered by the contract; provided, however, that the contracting officer, at any time after fifty per cent of the work has been completed, if he finds that satisfactory progress is being made, may make any of the remaining partial payments in full."

Even if the equitable lien of respondents had to be predicated upon an express allocation in the contract, and had to be confined to the 10% reserved fund, it is difficult to see how a distinction can be made between the two halves of the $1524.00. If satisfactory progress was not being made either by performance of the work, or by performance of the undertaking to pay for the labor and materials used, the contracting officer had the right to keep both halves of the $1524.00, and both halves remained in the same category so far as allocation might be concerned.

We submit, therefore, that the authorities sustain the equitable lien claimed by respondents, and that there are no reasons urged by petitioner which would require the Supreme Court to change the rule established by the Circuit Courts of Appeals in the different Circuits recognizing such a lien. The question remains, then, as to the relative rights of the petitioner and of the respondents in the contest of

their equities in the fund, and whether the petitioner is entitled to compete with respondents for the fund.

2

The Equity of Respondents in the Fund is Superior to any Right of the Surety.

The petitioner argues its right to the fund, under its point I, upon the assumption that the respondens have no equity in the fund in question, and stand in no better situation with reference to the fund than any general creditor of the contractor. And the petitioner studiously attempts to avoid subrogation as a basis of its claimed right. It contends that its right is a direct right based upon: (1) The indemnity agreement signed by the contractor. And (2) Equitable principles analogous to subrogation. And further (3) that the Court must uphold its right to the fund because a failure to make its right superior to the rights of the respondents would impair its rights under its contract (i.e. of indemnity) with the contractor.

A

The petitioner's Indemnity Agreement with the Contractor gives it no better right as against the Respondents than it obtains upon the theory of subrogation.

To begin with, we think the petitioner has proceeded upon an incorrect assumption of what the terms of the indemnity agreement are. We construe the Agreement to be, by its terms, an agreement for subrogation, and we think that its terms entitle it to be called nothing more than a basis for conventional subrogation; and that it adds no force or strength to the subrogation to which the Surety would, without the agreement, be entitled by operation of law. The agreement begins (R 31) by basing the indemnity agreement upon the Suretyship contract or relationship. It obligates the principal (R 44 Par. III) to "perform all the conditions of said bond" one of the conditions being to make prompt payment to all furnishers of labor and material. It

then, in event of the principal's default, expressly assigns to the Surety (R 45 Par. III) certain materials, and rights under sub-contracts. And it (R 46) expressly does not assign to the Surety the principal's right under the contract with the Government but provides that

> "the said Surety, as surety, shall be subrogated to all the rights and properties of the indemnitor in such contract, and that deferred payments and any monies and securities that may be due and payable at the time of such default, or on account of extra work or materials supplied in connection therewith, or that may thereafter become due and payable on account of said contract, shall be credited for any claim that may be made upon the said Surety by reason of its suretyship as aforesaid."

The instrument specifically provides for subrogation and it does not provide that the money coming to the contractor shall be paid to the Surety to reimburse it for claims against it which it may have paid but provides that such money shall be "credited for any claim that may be made upon the said Surety"; or, in other words, that the money shall be ear-marked to be applied to claims made on the Surety, even in advance of any payment of such claims by the Surety.

Regardless of the effect of the agreement as a basis for an expressly created equitable lien or as a basis for conventional subrogation, it is clear that whatever rights in the proceeds of the contract the agreement gives to the Surety are given to it by reason of its suretyship, as an incident to such suretyship, and adds nothing to the rights in the unpaid proceeds of the Contract which would exist in the Surety by operation of law.

If the indemnity contract be considered as an assignment to the Surety of the contract proceeds, separate and distinct from its relationship to the transaction as Surety, then the assignee would obtain no greater rights under the assignment than Hardaway got in Hardaway vs National Surety Company (211 U. S. 552) or the bank assignee in Henningsen vs U. S. F. & G. Co., supra. Petitioner claims (Brief Page 17) that this analogy is unsound because the

respondents have no equitable right whatever in the fund. Of course, petitioner's conclusion is correct if the Court holds that there is no equitable lien or equitable right in respondents. But if it be true, as we think the authorities heretofore cited show it to be, that the respondents as labor and material men do have a recognized equity in the fund, then petitioner's criticism of the analogy is not a valid one. And the necessary result of the petitioner's criticism of the analogy is an admission that the indemnity agreement is of no more force, considered from the standpoint of an assignment of the contract proceeds, than the assignments in the Hardaway and Henningsen cases, since the assignments in the latter two cases would have the effect of giving the assignees priority over the general creditors of the contractor, and consequently over the labor and material claimants if their position is no better than that of a general creditor.

The general rule is that when a contract of suretyship is made there arises an implied contract that the principal will indemnify the Surety for any payment the latter may make to a creditor of the principal in compliance with the suretyship obligation. 50 Corpus Juris 255.

In Springfield National Bank vs American Surety Co., (6th Cir.) 7 Fed. 2nd 44 (expressly approved in Fouts vs Maryland Casualty Co., 4th Cir. 30 Fed. 2nd, 357 and in Jenkins vs National Surety Co., 277 U. S. 258) the Court in speaking of an indemnity agreement on which the Surety relied, said (Text 45):

> "This provision did not give to the Surety Company any right that it otherwise did not have upon the execution of the bond, for there is always an implied obligation, in the absence of an agreement to the contrary that the principal will indemnify the Surety against loss resulting from the suretyship".

See also

Fouts vs Maryland Casualty Co., (4th Cir.) 30 Fed 2nd, 357, supra,

Jenkins vs National Surety Co., 277 U. S. 258 supra.

Petitioner's attempt (Brief Page 10 et seq) to distinguish the Jenkins case from the instant case is based upon its assumption that the respondents had no right to look to the contract proceeds here for payment of their claims and had no equity in such proceeds. And petitioner says that the indemnity agreement in the Jenkins case was a "very general one" (whatever distinction between it and the one in the instant case that phrase may mean), and also one which did not specify any particular portion of the principal's assets out of which the indemnity to the Surety was to come. And that here the contract proceeds were specifically made the security of the Surety. Even if petitioner's distinction were sustainable from a factual standpoint, the Jenkins case would still be a sufficient authority for the position taken by respondents. Respondents are obligees in the bond made by the principal and Surety. And the Surety was bound as surety to them. The bond was conditioned upon the prompt payment (not partial payment) to "all persons supplying the principal with labor and materials in the prosecution of the work provided for in said contract" (R 20). The indemnity agreement bound the principal to perform all the conditions of the bond (R 44). The Jenkins case (Text 267 of 277 U. S.) says:

> "Similar reasoning underlies the requirement of equity that the surety who holds the security of an insolvent debtor must give the benefit of it to the creditor for whom he is surety until the debt is fully paid."

But we think the attempted distinction would increase the force of the Jenkins decision as authority for the position of the respondents here with reference to the effect of the indemnity agreement. In the Jenkins case the obligee in the Surety's bond was a general creditor of the principal. And the independent indemnity agreement executed by the principal was used by the Surety in its attempt to place itself, not in the position of a secured creditor as it attemps to do here, but simply in the position of a general creditor whose claim against the principal was based upon the obligation expressed in the indemnity agreement. In

the two cases cited by petitioner on page 14 of its brief, viz: U. S. F. & G. Co., vs Centropolis Bank 17 Fed. 2nd, 942, (both of which were overruled by the decision in the Jenkins case), as well as in National Surety Co., vs Jenkins 18 Fed. 2nd, 707 (which was reversed by the Jenkins case in the Supreme Court), it was held that the separate contractual relationship between the principal and the Surety was a sufficient basis to make the Surety a general creditor of the principal and as such that the Surety had a right to file its claim as a general creditor. In none of those cases did the Surety attempt to claim a priority over its obligees. The decision in the Jenkins case in the Supreme Court was, therefore, definitely and distinctly to the effect that the indemnity agreement, no matter how considered, could not give the Surety any better right than it acquired by operation of law under the theory of subrogation. The cases heretofore cited dealing with the rights of laborers and materialmen, and of sureties which had paid labor and material claims all based the right of the Surety upon the subrogation, and not on an express indemnity agreement.

For the reasons stated and upon the authorities cited we submit that the petitioner's indemnity agreement with the contractor gives it no better right as against the respondents than it obtained upon the theory of subrogation.

B

The Subrogation Right of the Surety must be derived from the rights of the creditors whom it pays.

The petitioner argues that "equitable principles analogous to subrogation" entitle it to the reserved fund. And that it ought to be subrogated to the rights of the Government, notwithstanding it has performed none of the contractor's obligation to the Government, or to the rights of the contractor, although the contractor is not an obligee under the bond which the Surety executed as surety. It does not seem necessary to complicate the situation in this case by departing from the principles of subrogation on a search for principles analogous to subrogation. But it is not difficult

to see why the petitioner desires to avoid applying the principles of subrogation in a determination of its rights here.

It is difficult, however, to see how the surety can claim any right as subrogee of the contractor since the contractor is not a creditor whose claims have been paid. And it is still more difficult to see how a claim of the surety as subrogee of the contractor would give it any preferred standing as against the claims of the laborers and materialmen which the contractor owes and which he is in duty bound to pay. If the surety stands as subrogee of the contractor then its rights can rise no higher than his rights to the fund in question. It is clear, of course, that the government could have paid the money to the contractor in the ordinary course of events, during the progress of the contract, and the contractor could have spent the money as he saw fit. There is no principle which would involve the hampering of the government in its dealings with the contractor with respect to the payments to be made under the contract. But it is equally clear, we think, under the authorities hereinbefore cited as authority for the existence of an equitable lien in favor of laborers and materialmen, or in favor of the surety who has paid the labor and material claims, that where the situation in connection with a particular contract develops to the point where the contract has been performed so far as the government is concerned and there remains simply a question of equitable distribution of the unpaid balance of the contract price, laborers and materialmen have a superior right in the fund to the right of the insolvent contractor. If that were not true a contractor's assignment of his rights to such fund to a bank would take precedence over the rights of the laborers and materialmen to be paid out of such fund, or would take precedence over the right of a surety, who has paid labor and material claims, to be repaid out of such funds. So that on the surety's contention that it stands in the shoes of the contractor, the question arises as to the relative equities of the laborers and materialmen on the one hand and of the insolvent contractor on the other hand to the fund. And we think it requires

no additional citation of authority to establish the proportion that as between those two classes of claims the laborers and materialmen have a superior right to the contractor. In bankruptcy, the fund is in the hands of a court of equity to be delivered to the claimant most equitably entitled to it. If the contractor has a better right than the laborers and materialmen, then it would go to the general creditors instead of to the laborers and material claimants, absent any other phase of the controversy. That would be the result of any theory that the insolvent contractor, or one standing in his shoes has a superior equity to the labor and material claimants.

In support of its claim that it is entitled to the fund in question by subrogation to the rights of the Government under the Gray contract, petitioner relies on some cases which it is not necessary to discuss, but principally on

Prairie State Bank vs United States 164 U. S. 227 and
Henningsen vs United States 208 U. S. 404

In the Prairie State Bank case the surety completed the perfromance of a contract on the contractor's default, and thereby performed the obligation to the United States. It was no departure from the principles of subrogation to say that the Surety, which had completed the construction called for in the contract became subrogated to the rights of the Government which was the obligee for such completion. And the right which the Surety acquired by subrogation to the right of the creditor it paid was held good as against a bank assignee. In the instant case, the contractor himself completed the contract and therefore satisfied the obligation of the contract and of the bond to the Government.

In the Henningsen case the contest was between a surety which had paid all of the material and labor claims, and a bank assignee of the contractor. And it is believed that the whole contention of the petitioner in the instant case is based upon its theory that in the Henningsen case the Supreme Court failed to hold that laborers and materialmen

had any rights to which the Surety could be subrogated, and that, consequently, the rights accorded the Surety must have been derived by subrogation to the rights of the Government.

We have already discussed the cases in the Circuit Courts of Appeals which have accorded definite recognition to the equitable rights of laborers and materialmen, including Belknap Hardware Company vs Ohio River Co., 271 Fed. 144 which concluded that the subrogation involved in the Henningsen case was in fact a subrogation to the rights of the laborers and materialmen. The Henningsen case, in the lower Court, is

Henningsen vs U. S. F. & G. Co., 19th Cir. 143 Fed. 810
In that case the Court said (Text 814):

> "Whereas in the Prairie State Bank and Rundle cases, supra, the surety is compelled to make good the default of his principal as respects the Government, the surety is, as was distinctly held in those cases, entitled to be subrogated to the rights of the Government. **Upon precisely the same principle the surety is entitled to be subrogated to the rights of laborers and materialmen,** whereas, in the present case it is compelled by reason of the obligations of the bond to pay them for labor and material because of the default of its principal."

In its opinion affirming the Henningsen decision of the Circuit Court of Appeals, the Supreme Court did not state in so many words, the right to which the Surety was held to have been subrogated. It did, however, affirm the lower Court and approve its conclusions. And, speaking of the Surety's right, the Court said:

> "It paid the laborers and materialmen and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and materialmen were paid."

Even if the Supreme Court did not, in express terms, define the rights of laborers and materialmen in the Henningsen case, or state whether it was to their right or to the right of the United States that the surety was subrogated, it did

recognize an equitable obligation on the part of the Government to see that the laborers and materialmen were paid. And either the laborers and materialmen had rights to which the surety, by paying all of their bills, was subrogated, or else the Surety succeeded to the right of the United States subject to the equitable obligation to the laborers and materialmen. And it succeded to the right of the United States, not by performing the contract, but by relieving the United States of all its equitable obligation to the laborers and materialmen. In either view of the case, the result would be the same in the instant case, because, until the Surety relieves, by performance, the whole of the obligation of the United States, it would not be entitled to be subrogated to rights of the United States.

The views expressed by the Belknap Hardware Company case, and by the Henningsen case in the Circuit Court of Appeals logically follow the recognition of any equitable rights in the laborers and materialmen. Only by denying them any equitable rights, even though such rights (and they are) subordinated to the right of the Government for complete performance, can any conclusion be reached other than that, by performing its principal's obligation to the labor and material obligees in its bond, the Surety becomes subrogated to the rights of the obligees whom it pays. All of the Federal Courts have recognized the equitable rights of the laborers and materialmen, and no injurious effect on the Government's rights have resulted.

We submit, therefore, that such right as the Surety has in the instant case comes to it through subrogation to the rights of the creditors it pays, and not through subrogation to the rights of the contractor of the United States.

C

Does Recognition of the Equitable rights of the respondents constitute an impairment of the petitioner's rights under its indemnity agreement?

This contention of petitioner (Brief, Page 29) proceeds upon the assumption that a superior right of the Surety is being subordinated to an inferior right of the respondents by the arbitrary action of the Court. Whereas the instant case is for the purpose of deciding whether or not the rights of the respondents are superior or inferior to the rights of petitioner.

Of the three cases cited by the petitioner as supporting its contention, the two in the lower Federal Courts simply involve the proposition that an obligee in a bond, conditioned on the princapal's performance of a contract, releases the Surety by not complying with the contract provisions governing the times of payment of the contract price. The Prairie State Bank case, already discussed, involved a contest between a surety, and a bank assignee of the contractor.

A decision that the equitable rights of the respondents are superior to those of the petitioner would no more impair petitioner's contract than does any enforcement of a superior lien impair the contract of any holder of an inferior lien.

A mortgage on real estate is liable to be impaired by a superior lien, whether the superior lien be a first mortgage or a lien for work or materials. The petitioner took its contract from Gray, and assumed toward the respondents the status of surety guaranteeing that Gray would perform his obligations to them. The contract was taken subject to the acquisition by the respondents of the equitable rights which the cases had upheld. Just as a mortgage on real estate is taken subject to the risk of liens of laborers and materialmen engaged in the construction of improvements on the real estate, if, subsequently, they are not paid for

their labor and materials. And the enforcement by a Court of their superior lien does not operate as an impairment of the contract represented by the mortgage. The question here is whether the respondents' equity is superior to that of the petitioner. If it is superior then its enforcement cannot operate as an impairment of the petitioner's contract with the defaulting contractor. If it is not superior, then respondents have no right to have it enforced. So the petitioner's objection that to enforce respondents' equity, if it is superior to that of petitioner, would be to impair petitioner's contract is begging the real question before the Court.

D

The effect of Petitioner's relation-back theory.

The petitioner argues its "relation-back" contention in connection with its theory that the indemnity agreement gives it a better right than it would acquire by subrogation, although the relation-back principle is applied by the cases cited by the petitioner to rights based on subrogation.

The relation-back principle is stated thus in 50 Corpus Juris 255:

> "This implied contract arises when the suretyship is made and when payment is made thereunder. Payment merely fixes the amount of payment for which the principal is liable and relates back to the time when the contract was entered into; but the theory of relation cannot be invoked to do injustice as against third parties."

See also

Gilbertson vs Northern Trust Co., (N. Dak.) 207 NW 42
U. S. F. & G. Co. vs Woolridge 268 U. S. 234,

in which latter case the Supreme Court said:

> "The doctrine of relation is a legal fiction intended to promote the ends of justice. It is never allowed to defeat the collateral rights of third persons lawfully acquired."

Under those authorities as well as under
Jenkins vs National Surety Co. (Supra) 277 U. S. 25
Exchange State Bank vs Federal Surety Co., supra
Fouts vs Maryland Casualty Co., supra.
Springfield vs American Surety Co., supra

the relation back theory can have no effect on the rights of the respondents who are obligees of the Surety, regardless of the fact that the superior equity of the respondents became operative subsequent to the origin of the suretyship contract. It might as well be argued that the relation back theory would serve to give the surety priority over any claims of the other obligee in the bond, the Government, in event of default subsequent to the inception of the suretyship.

E

The petitioner has no right to compete with the respondents for the fund until the respondents' claims are paid in full.

The respondents are obligees in the bond on which the petitioner was surety.

Equitable Surety Co., vs United States 234 U. S. 448
United States vs National Surety Co., 92 Fed. 549
Henningsen vs U. S. F. & G. Co., 134 Fed. 810
Glades County Bank vs Detroit F. & S. Co., 57 Fed 2nd 449.

That being so, the contest here is between a surety on the one hand, and obligees (or creditors of the principal) whose claims against the principal have not been fully satisfied, on the other hand.

The petitioner takes the position that the complete obligation of the bond to appellees was satisfied by the payment into Court of the penalty of the bond. It tentatively suggests, though apparently without confidence in the suggestion (Brief, Page 27) that the condition in the bond requiring the principal to make prompt payment to all persons supplying him with labor and materials means that if the principal should pay small portions of each labor and

material bill, just so he made sure that all claimants got a little something each, the condition would be performed, according to the intent and purpose of the bond.

The bond required the principal to pay all labor and material bills. The Surety guaranteed to the laborers and materialmen that the principal would perform that condition of the bond. It is true that the amount that could be recovered from the Surety for breach of this condition was limited to a certain figure, but the limitation on the amount of recovery against the Surety did not limit or purport to limit the extent of the obligation to pay all labor and material bills. The duty of the principal was not to pay $3940.00 worth of labor and material bills, but to pay them all, and the Surety guaranteed he would do it. That duty is still unperformed. The Surety, by paying the $3940.00 put itself in a position to defend against further demands on it by the obligees, but only because that amount was all it had agreed to pay for a breach by the principal of his duty of payment. But the Surety claims now that it cannot only use its payment of $3940.00 as a defense against further recovery, but that its payment gave it the right to take the offensive against and in competition with the unpaid creditors of its principal.

The situation is analogous to that in Maryland Casualty Co., vs Fouts 11 Fed. (2nd) 71 (expressly approved in the Jenkins case, supra, (277 U. S. 258) where the Court said:

> "The penalty of the bond in this case, it is true, was $50,000.00, and, subsequent to the bank's failure, the amount of the penalty was paid by the surety; but the whole obligation to the State was by no means extinguished. On the contrary, there remained a balance of $39,579.14 due. The condition of the indemnity bond was to pay upon demand all money deposited in said bank, no limitation in amount being placed thereon, as set forth in full in the provision of the bond hereinbefore set forth. Manifestly, the surety therein could not assert a claim, either by way of subrogation or otherwise on account of what it saw fit to pay on its bond indemnity, as an admitted liability, leaving unpaid such portions thereof as it saw fit-not to settle."

The same language, substituting "contractor" for "bank" and "laborers and materialmen" for "the state", and "labor and material claims" instead of "money deposited in said bank", could be fitly used in the instant case.

Suppose the unpaid balance of the contract amounted to $3940.00, the exact penalty of the bond. The Surety then would pay into Court the penalty of its bond, and, notwithstanding the failure of its principal to perform his duty of payment, a duty which the surety guaranteed he would perform, would claim complete reimbursement. It would, therefore, suffer no loss for breach of the principal's obligation, but would cause the entire loss to fall upon the very persons to whom its principal and it owed the duty of payment. The principle is the same with respect to the partial reimbursement it seeks here in competition with its unpaid obligees.

In

State for the Use of LeFlore County vs First National Bank of Greenwood, 66 Fed. (2nd) 9

the surety had executed bonds which guaranteed some, but not all, of a County's deposit in a bank. Upon the failure of the bank, the surety paid the County authorities the full amount of the bond penalties, took assignments from the bond obligees of their claims against the bank to the extent they had been settled by the bond penalties, and sought to prove its claim against the insolvent bank. The Court held that the surety had no right to prove its claim against the bank in competition with the County, even though the remaining County claims were for deposits which were not protected by the bonds. The Court said:

> "This, in connection with his other findings, was a finding that, though the surety became bound for only a part of the debt, the obligation of their principal, the bank, was an indivisible one for all County funds including those of the Sheriff and tax collector. The conclusion that under these circumstances the sureties are entitled to subrogation is in direct conflict with the general rule that one is not entitled to be subrogated

> to the rights and securities of a creditor until the claim of the creditor against the debtor has been paid in full."

And later in the same opinion announced as a rule:

> "The surety who pays the amount called for by the bond does not thereby become subrogated to the rights of the creditor to the prejudice of the balance due the latter."

This rule is in accord with our previous quotation from Maryland vs Fouts (supra, 11 Fed. (2nd) 71), in which latter case the Court quoted from United States vs National Surety Company, 254 U. S. 73, as follows:

> "This result is in harmony with a familiar rule of the law of subrogation under which a surety liable only for part of the debt does not become subrogated to collateral or to remedies available to the creditor unless he pays the whole debt or it is otherwise satisfied."

In Jenkins vs National Surety Co. (supra, 277 U. S. 258), where the penalty of the bond was insufficient to satisfy the whole claim of the obligee against the principal, the Supreme Court said:

> "The established rule that the surety may not claim subrogation against an insolvent debtor until the creditor is paid in full is a recognition of the inconsistency of that position. (Citing cases.) The rule would go for naught if, by claiming indemnity instead of subrogation, the surety would achieve the same result. The same policy against permitting a surety to compete with a creditor for the insolvent debtor's assets requires that the surety be denied subrogation to security given by a creditor for several debts for only one of which the surety is obligated. Similar reasoning underlies the requirements of equity that the surety who holds the security of an insolvent debtor must give the benefit of it to the creditor for whom he is surety until the debt is fully paid." (Citing cases.)

CONCLUSION

In the instant case the surety, who guaranteed full payment by its principal of all the claims of appellees, is in direct competition with the creditors of the principal. The

payment by the surety of the full penalty of the bond did not result in the performance by the principal of the duty undertaken by the bond, the performance of which the surety guaranteed. We submit that it is clear, in reason and principle as well as upon the authorities referred to, that:

(1) The appellees have an equitable lien on or priority right in the fund in dispute.

(2) That the appellant surety has no right in the fund to the prejudice of the claims of appellees and their right to full, not partial, payment of the claims.

Therefore, the judgment of the Court below is correct and should be affirmed.

Respectfully submitted,

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Attorney for Respondents.

The assignment contained in the indemnity agreement upon which petitioner so strongly relies is absolutely void under the provisions of Sec. 3477 of the Revised Statutes. London & Lancashire Indemnity Company v. Endres, 290 Fed. 98; National Bank of Commerce v. Downie, 218 U. S. 345, 31 Sup. Ct. Rep. 89, 54 L. ed. 1065; Nutt v. Knut, 200 U. S. 12, 26 Sup. Ct. Rep. 216, 50 L. ed. 348.

R. S. Sec. 3477; May 27, 1908, c. 206, 35 Stat. 411:

"ASSIGNMENTS OF CLAIMS VOID. All transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders, or other authorities for receiving payment of any such claim, or of any part or share thereof, except as provided in section 204 of this title, shall be absolutely null and void, unless they are freely made and executed in the presence of at least two attesting witnesses, after the allowance of such a claim, the ascertainment of the amount due, and the issuing of a warrant for the payment thereof. Such transfers, assignments, and powers of attorney, must recite the warrant for payment, and must be acknowledged by the person making them, before an officer having authority to take acknowledgments of deeds, and shall be certified by the officer; and it must appear by the certificate that the officer, at the time of the acknowledgment, read and fully explained the transfer, assignment, or warrant of attorney to the person acknowledging the same. The provisions of this section shall not apply to payments for rent of post-office quarters made by postmasters to duly authorized agents of the lessors." Title 31, U.S.C.A. Sec. 203.

Respectfully submitted,

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